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Dow Theory Letters

"The Market as Interpreted under the Dow Theory"

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NOTHING SACRED. The experienced trader regards his capital in much the same way that a carpenter views his tools. When there is a job to be done the tools are put to good use; when the task is completed the tools are returned to the shop for safekeeping. The trader, if he is reasonably confident of the situation, will take his position and ride the trend until danger signals (or prudence) dictate his withdrawal from the market. He will then bank his capital and spend his profits for current needs. He does not regard his money as a sacred fund to be used only in time of emergency. This is the hard-headed approach, but it is one that is seldom accepted by conservative investors.

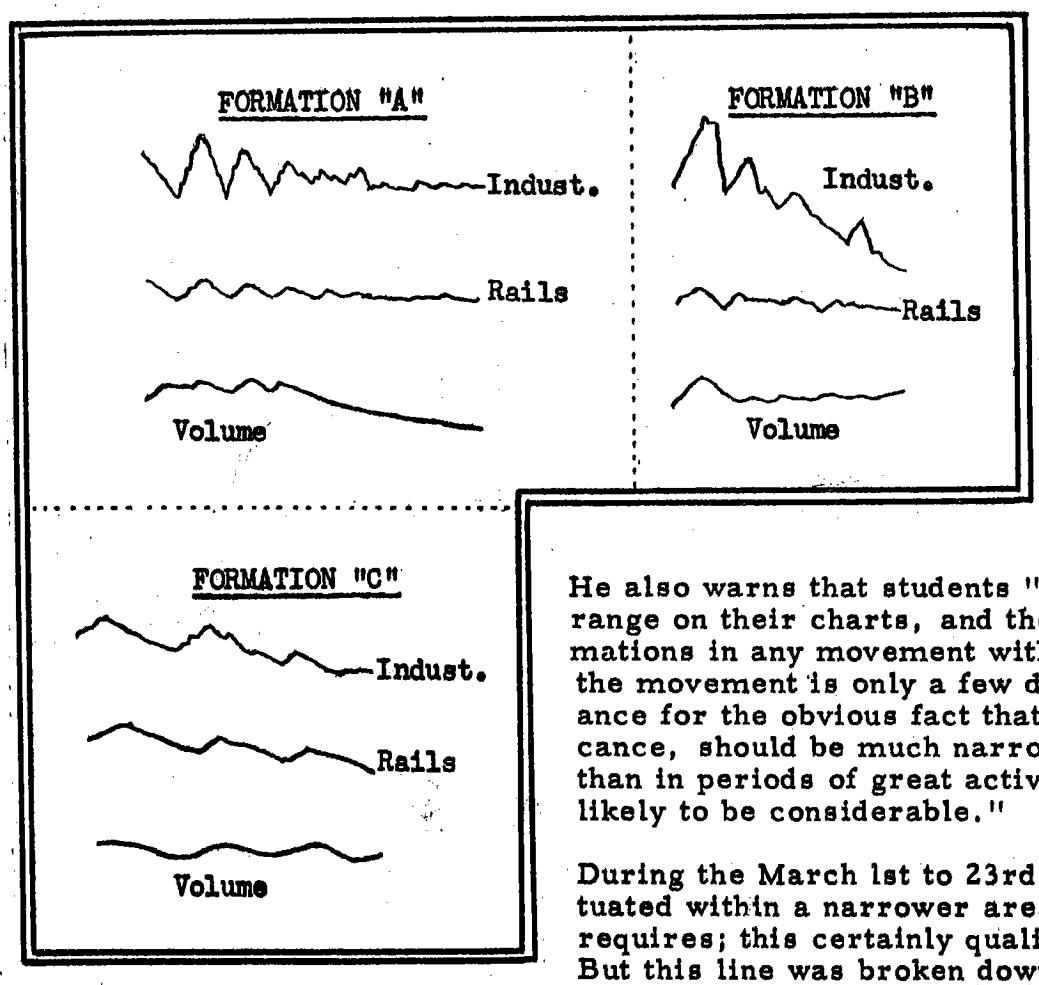
In contrast to the trader, many individuals, institutions, banks, and trusts require that their money be fully invested at all times. This policy is diligently pursued while the trend of the market is ignored. Continued income is considered far more important than increase of capital or avoidance of loss, and accounts are often heavily laden with bonds and high-grade preferreds. The result of this type of thinking can be loss of capital growth during primary bull trends and shrinkage of assets during primary bear trends. Whereas the trader will not hesitate to spend a portion of his profits while waiting perhaps a year for an opportune moment to enter the market, the investor will naively endanger the equivalent of ten years' dividends in order to keep his funds constantly at work. During extended bull markets the fetish of remaining fully invested may show only periodic flaws, but during severe reactions or bear markets this policy reaps its own disastrous reward.

Investors forget that there are certain periods (bear markets) when the best commodity in the world is cash. During primary bear markets the purchasing power of the dollar is constantly increasing, and there has never been a period of extended inflation which was not followed by a period of (usually violent) deflation. Readers who consider that the 1957-58 recession (a secondary reaction) was a refutation of this principle should study those periods when the primary trend of stocks and business has reversed itself from bull to bear market.

WOLF? A few readers infer that I am overly cautious because I often take space in these Letters to discuss bearish possibilities in the averages and even previous bear market phenomena. Yet older subscribers know that I have never remotely implied that the market's primary trend was anything but up, and I continue to hold this view. Following the 1937 bear market signal, Robert Rhea (the greatest Dow Theorist of his time) estimated that only 25% of his thousands of informed readers acted on the implications of the averages (and his unhedged advice) and sold out. I have hoped, by consistently hinting at the possibility of an eventual turn in the tide, that my readers might fare a little better than Rhea's. It may be that in this I am being overly optimistic myself. This Service is a business, however, and I am revealing no secret when I say that there are two ways in which a market pundit can lose readers; the first is to write continual nonsense, and the other is to leave subscribers without the price of a renewal subscription during the next bear market.

QUESTION. "On page 3, Letter 60, you state that on Monday (March 23) both averages violated the 'line' which had formed since March 1st. But does not the 5% rule for lines require a 30 point difference (highs and lows) for the industrial average at 600? And doesn't the 5% rule require a corresponding 8 point difference for the rail average at 160? According to my calculations between March 1st and 23rd the industrial differential was 9 points or 1-1/2% of 600; the rail average showed a 5 point or 3.2% differential during the same period. Where is my error?" (N.S.H. Spartenburg, S.C.)

ANSWER. First, new readers should know that "lines" are formations within which buying and selling are very evenly matched. Hamilton taught that if, after one of these appraisal periods, both averages jointly penetrated the line's upper limits the buying (accumulation) was of better character than the selling (distribution), in which case prices would continue higher for an indefinite period of time. Conversely, a joint penetration through the lower line limits was proof of the fact that selling was more informed than buying, and this was a prediction of lower prices for an indeterminate period.



Robert Rhea tabulated all the lines ever mentioned in Hamilton's editorials; he then evolved the following definition: "A 'line' is a price movement extending two or three weeks or longer, during which period the price variation in both averages moves within a range of approximately 5%." This definition was not meant to be an exact formula, and Rhea notes that the narrower the line limits and the longer the line the better the prediction on a final penetration by both averages. He also warns that students "...like to measure out a 5% range on their charts, and then imagine they detect line formations in any movement within that range--sometimes wh the movement is only a few days long. They make no allowance for the obvious fact that lines, to be of much significance, should be much narrower in a dull sluggish market than in periods of great activity when the price change is likely to be considerable."

During the March 1st to 23rd formation, the averages fluctuated within a narrower area than even Rhea's definition requires; this certainly qualifies the structure as a line. But this line was broken downside, an occurence which is seldom seen during a bull market. Rhea tells us that in a bull market, the most validity is attached to lines that are jointly penetrated upside; the exact converse of this is true during bear markets. He also states that the joint penetration of a line downside in a bull market should always be treated with care, since this is a movement (and a prediction) against the primary trend, and it does not carry the same import as a penetration in the direction of the main trend.

In a bull market one should never short stocks on a downside line penetration, but purchases can definitely be made on the joint upward penetration of a line. The best predictions are obtained with lines which are narrow and extended, and in which the fluctuation within the line gradually decreases as volume diminishes. Areas which produce obvious upward or downward pointing zig-zag structures in one or both averages should not be treated as lines; technically lines should give the appearance of equilibrium and gradually narrowing fluctuations.

Pictured here are three common formations. In each formation (A-B-C) rails and industrials have been fluctuating within a theoretical 5% area, yet only one of these formations qualifies as a line. Formation "A" is a definite line; both averages are moving in a manner which suggests gradual equilibrium as volume diminishes. Formation "B" shows industrials declining as rails form a pseudo-line of their own. But a single line-like structure on one

average does not make a true line. Formation "C" is a definite downward-pointing zig-zag formation and is undoubtedly a forecast of lower prices. Nevertheless, since the fluctuations in "C" fall within 5% on both averages, many people mistakenly label these gently sloping zig-zags as lines.

OPINIONS. Occasionally, this pundit indulges in a bit of quackery. After puzzling over the price movements, I attempt to "beat the gun" by hazarding a guess concerning the next general direction of the market. These "predictions" are always prefaced with a phrase such as "I believe," "it seems to me," or "I will now guess." Qualifications are used in order to separate my opinions from the far more important verdicts of the averages themselves. The last prediction appeared in Letter 59 and was written on March 18. It stated, "I believe, based on past precedent and present volume indications, that the next major move will be up." The action of the market since Letter 60 has not changed my opinion; I continue to believe that the next broad movement will be up.

PRICE MOVEMENTS. Letter 60 emphasized that "the primary trend of stocks is up." This Letter also stated that if "...the D (February) lows are approached and volume diminishes on the decline, it will be a bullish sign. As long as one or both averages hold above the D lows it will continue bullish." The action of the market since Letter 60 left little doubt as to the near-term trend. Last week as the two averages declined, volume dropped drastically. At the lows we witnessed four consecutive days on which volume each day dropped under 3 million shares. We have not seen an area of such consistent low volume since August of 1958. Even more interesting was the fact that on the decline (L-O) industrials held 51¢ above their lows of Point I (601.18) while rails refused by 71¢ to violate their February lows at Point D (157.94). Readers who doubt the importance of previous support points in the averages received a graphic lesson on this low-pressure sell-off. Many subscribers inquired as to whether this dramatic manifestation in the price movements indicated a "buy-spot." My answer was that I believed that the lows at Point O would represent the lows of the entire decline, and that speculative purchases were warranted in view of the complete lack of selling pressure as Point I on industrials and Point D on rails were approached. A much safer buy-spot will appear if, on the next decline, one or both averages holds above the recent lows at Point O (indust., 601.71; rails, 158.65) as volume diminishes. A study of the price movements over the years will demonstrate that purchases made on the second decline (a true buy-spot) are safer and subject to fewer losses than purchases made on low-volume declines where the investor guesses that the market has bottomed-out.

Last week's action illustrates the value of keeping charts of the averages and volume, and I assume that subscribers who followed this procedure recognized the strength in the situation and refrained from making sales as prices worked lower.

During the final three days of last week both averages spurted ahead as volume expanded bullishly. Industrials advanced $10.22 during the three days, which is a rather impressive figure even for these times. This suggests some sort of a correction during the period directly ahead. If, on the next decline, one or both averages hold above the O points (previously given) as volume diminishes, purchases can be made and we will call the area a buy-spot. Subscribers have been reading about that elusive 167.38 point on the rail averages for almost three months now, and they are probably as bored with it as I am. However, the rails must eventually confirm the industrial advance or this market will not receive a clean bill of health. Until rails better their former highs of January, they must move "in gear" or in the same direction as industrials. Many serious reactions have resulted from the persistent refusal of one average to confirm the action of the other. Decreasing volume on advances, increasing volume on declines, and divergence (the two averages moving in opposite directions) are all danger signals, and the price movements should be studies with these indications always in mind.

Should a buy-spot appear, any of the following stocks may be purchased: DOW CHEMICAL FRAUHAUF TRAILER, EASTERN AIRLINES, PAN-AMERICAN WORLD AIRLINES, MACK TRUCK, ST. REGIS PAPER, BECKMAN INSTRUMENTS, CHRYSLER, WILSON & CO., WHITE MOTOR.
(written April 5, 1959 - 3 p.m.)